

Bond Perspectives

Pre-Refunded Municipal Bonds

Pre-Refunded Municipal Bonds: Quality & Income

Finding a high quality fixed income investment with high current income can be an important step toward achieving your investment goals. Pre-refunded municipal bonds can provide investors with both of these features in addition to typically providing tax-free interest income.

Pre-refunded municipal bonds are among the highest quality municipal bonds available. The income and principal from pre-refunded municipal bonds is normally secured by an irrevocable trust of U.S. Treasury securities. Thus, the payments from pre-refunded municipal bonds are no longer dependent upon the revenue stream or tax collections of the issuing municipality. Because of this enhanced security, pre-refunded municipal bonds generally carry a 'AAA' rating.

Since the income earned from municipal bonds is generally federally tax-exempt, and in most cases, state and local tax-exempt as well¹, an investment in pre-refunded municipal bonds may result in more net disposable income than a comparable investment in taxable securities.

Understanding Pre-Refunded Municipal Bonds

Pre-refunded municipal bonds are created when municipalities issue new debt to refinance debt issued when interest rates were higher. Once the refinancing is completed the issuer uses the proceeds of the new issue to purchase collateral, such as U.S. Treasury securities, and places these securities in an escrow account. The income from the collateral is then used to pay interest and principal on the original debt until the bond is called. The call date and price is set when the refinancing is completed; usually the call date is within 10 years of the refinancing, and the call price is set at a premium, e.g. 101.00, or par (100.00). The cash flows (revenues or taxes) that went to the original issue are now diverted to the new issue.

Advantages of Pre-Refunded Municipal Bonds

Higher Cash Flows

As pre-refunded bonds were generally issued when rates were higher they are now priced at a premium to their par value. Some investors may be reluctant to purchase premium priced bonds since, at first glance, it doesn't seem to make sense to buy a bond at a premium and only get back par at the refunding date – less than the original investment. However, pre-refunded municipal bonds are often offered with higher yields than par bonds of similar quality and maturity. This, combined with the higher coupon inherent in pre-refunded bonds, creates a higher cash flow over the life of the bond.

Price Stability

Higher coupon bonds, such as pre-refunded municipal bonds, also tend to exhibit less price volatility in a rising interest rate environment than lower coupon bonds.

¹ Interest on municipal bonds is generally exempt from federal income tax. However, some bonds may be subject to the alternative minimum tax (AMT). Typically, state tax-exemption applies if securities are issued from within one's state of residence and, local tax-exemption typically applies if securities are issued from within one's city of residence.

Common Types of Collateral

Pre-refunded municipal bonds are collateralized by some of the safest securities available. The most common types of collateral used are:

- U.S. Treasury Securities
- State and Local Government Securities (SLGS)
- U.S. Agency Securities: FNMA, FHLMC, TVA, HUD and FHA
- Aaa/AAA rated Guaranteed Investment Contracts (GICS)

As pre-refunded bonds are backed by these high quality securities they are considered to be rated 'AAA.' At the time of refunding the issuer can apply to the credit rating agencies – e.g. Moody's Investors Service, Standard & Poor's and Fitch Ratings – for a re-rating, at which point a 'AAA' rating would normally be assigned. However, some issuers choose not to apply for a re-rating; these pre-refunded bonds keep their initial rating, but carry an implied rating of 'AAA' because of the quality of the securities collateralizing the issue.

High Quality Doesn't Always Mean Low Return

Because of the high credit quality of pre-refunded bonds many investors assume that their return will be low. However, because pre-refunded bonds generate tax-exempt returns, an investor may be able to earn a higher taxable equivalent yield (TEY) than they would on a comparable maturity Treasury security.² Ask your Financial Advisor for the prevailing rates on both pre-refunded municipal bonds and Treasury securities as well as a copy of the Taxable Equivalent Yield chart for your home state.

Investments Considerations

As with any fixed income security, investors must consider the investment risks associated with pre-refunded municipal bonds:

Interest Rate Risk

Interest rate risk is the risk that the market value of securities might rise or fall, primarily due to changes in prevailing interest rates. Like all fixed income securities, pre-refunded municipal bonds are susceptible to fluctuations in interest rates; if interest rates rise, bond prices will fall and, inversely, if interest rates fall, bond prices rise. However, due to the higher coupon and relatively short-term maturity, the duration (sensitivity to interest rates) of a pre-refunded bond is lower than that of a comparable quality and maturity bond, hence reducing interest rate risk.

Credit Risk

Credit risk is the risk that the issuer might be unable to pay interest and/or principal on a timely basis. However, credit risk is eliminated as pre-refunded municipal bonds are backed by a portfolio of high quality U.S. Treasury, Agency or other 'AAA' rated securities. Pre-refunded municipal bonds are considered second only to U.S. Treasuries in terms of credit quality.

Reinvestment Risk

Reinvestment risk is the risk that proceeds from the current investment, both interest payments and principal, may be reinvested in a lower interest rate environment. For example, after interest payments are made, available investments may offer lower yields than the current investment. Reinvestment risk is greater on short- to intermediate-term instruments (such as pre-refunded municipal bonds) and should be considered before investing.

Secondary Market Risk

While a secondary market exists for pre-refunded municipal bonds, if you sell your pre-refunded municipal bonds prior to maturity, the price you receive may be more or less than the original cost, depending on market conditions at the time.

Pre-Refunded Municipal Bonds may be suited for conservative investors who are looking for high credit quality combined with federally tax-exempt income.

For more information on Pre-Refunded Municipal Bonds, or any fixed income product or service, please contact your Morgan Stanley Smith Barney Financial Advisor.

²A taxable equivalent yield is only one of many factors that should be considered when making an investment decision. Morgan Stanley Smith Barney and its Financial Advisors do not offer tax advice; investors should consult their tax advisors before making any tax-related investment decisions.

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J06/09